Addressing the Macroeconomic Consequences of Aging in Cyprus: The Case for Pension Reform

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Abstract
This paper examines the challenges to the Cypriot pension system posed by aging, and builds the case for pension reform based on a small open economy overlapping generations model in the tradition of Auerbach-Kotlikoff. In the absence of reforms, the model suggests that tax increases needed to finance age-related expenditures will have devastating effects on the economy. Although the reforms envisaged in the Convergence Program would lessen the adverse macroeconomic effects, welfare declines primarily because it relies on payroll tax increases. This paper proposes to increase the retirement age in tandem with life expectancy; switch the indexation of all pension benefits to prices; realign the relative generosity of public-versus-private pension benefits; and use less distortionary consumption taxes to finance age-related expenditures. These reforms further mitigate the macroeconomic consequences of aging and safeguard households’ welfare.

Keywords: Pension reform, demographic shock, dynamic general equilibrium model, Cyprus.